Project	**Financial Instruments: Recognition and Measurement**
Topic	**Redeliberation of ED/2009/7 *Financial Instruments: Classification and Measurement* – Accounting for embedded derivatives**

Objective of the paper

1. **This paper discusses the accounting for hybrid contracts as proposed in ED/2009/7 *Financial Instruments: Classification and Measurement* ('the ED').**

2. The paper includes:

   (a) an overview of the proposals in the ED;

   (b) an overview of the FASB's tentative decisions;

   (c) a staff analysis of comments received from constituents and during other outreach activities;

   (d) possible approaches for the Board; and

   (e) a staff recommendation (set out in paragraph 29).

3. This paper interacts with paper agenda paper 2, which addresses the issue of own credit risk in financial liabilities.

4. One way of addressing that issue is the Board deciding to require one of the two approaches in agenda paper 2. If the Board decides that, then this paper recommends the Board confirm its proposals to eliminate embedded derivative accounting for **all** hybrid contracts with a financial host.

5. If the Board decides **not** to adopt one of the two approaches in agenda paper 2, then this paper recommends that the Board maintains the requirements for the

bifurcation of hybrid contracts with a financial liability host, but to eliminate embedded derivative accounting for hybrid contracts with a financial asset host.

6. Therefore, the staff recommendation is split in two in this paper.

7. This paper does not address transition. Many of the comment letters proposed that grandfather hybrid contracts be grandfathered if the Board finalises the proposals in the ED. We will address this issue when we address transition.

8. This paper also does not address contractually subordinated interests (tranches in ‘waterfall’ structures).

Overview of the proposals in the ED

9. The ED proposes to eliminate bifurcation accounting for embedded derivatives in hybrid contracts where the host is *within* the scope of IAS 39 *Financial Instruments: Recognition and Measurement* (herein referred to as ‘financial hosts’).

10. Many respondents to the discussion paper (‘the DP’) *Reducing Complexity in Reporting Financial Instruments* highlighted that the current requirements in IAS 39 including its accompanying guidance are complex, rules-based and internally inconsistent. The Board shared these views in its deliberations on the ED.

11. The ED did not propose any changes to hybrid contracts where the host is *outside* the scope of IAS 39 (eg leases with an unrelated foreign currency embedded derivative). The Board was aware of the importance of the issue, but decided to defer any decisions in this area until it deliberates scope and hedge accounting because of the interaction of these issues. For such hybrid contracts the existing guidance in IAS 39 would be retained for the time being if bifurcation of embedded derivatives is required.[1]

[1] See BC47 of the ED.

12. The remainder of this paper only addresses the accounting for hybrid contracts with financial hosts.

13. For hybrid contracts with financial hosts the entire hybrid contract would be assessed against the classification model in the ED and hence an entity would assess the entire hybrid contract as to whether the contract:

    (a) is managed in a business model that has the objective to on a contractual yield basis; and

    (b) has the required contractual cash flow features.

14. As a result, some hybrid contracts would be accounted for at amortised cost in their entirety (if the classification criteria are met) while others would be measured at fair value through profit or loss in their entirety.

15. As noted in paragraphs BC44-BC46 of the ED, during its deliberations the Board discussed three approaches of the way forward for bifurcation accounting where the host is financial:

    (a) keep the current requirements in IAS 39

    (b) use 'closely related' (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) as the classification criterion for the contract in its entirety

    (c) use a single classification approach for all financial assets and financial liabilities including hybrid contracts.

16. The Board rejected the first two approaches as they would still rely on the 'closely related' assessment which has been identified as troublesome by many commentators and could lead to outcomes that are inconsistent with the general classification criterion of 'basic loan features' as set out in the ED (that is, there would be two classification models). The Board also believed that these approaches would not improve the reporting for financial instruments.

17. The Board decided to use the classification model for the entire hybrid contract as this would ensure only one classification model is applied to all financial

instruments within the scope of IAS 39. This promotes comparability by ensuring consistency in classification.

FASB's tentative decisions

18. The FASB has tentatively decided to keep its existing guidance on bifurcation of embedded derivatives for hybrid contracts within the scope of its financial instruments project. However, instead of using the guidance to determine the unit of account for classification and measurement purposes the FASB has tentatively decided to use the guidance as part of the classification model.

19. Consequently, if the current guidance in US GAAP would have mandated bifurcation, the entire hybrid contract would be accounted for at fair value through net income under the FASB tentative model. If bifurcation would not have been required under the existing guidance and the other criteria under the FASB's classification model are met, an entity could elect to measure the hybrid contract at fair value through other comprehensive income if it so chooses.

20. As the existing guidance on bifurcation would be retained, the FASB approach is similar to the approach described in paragraph 15(b) in terms of the items required to be measured at fair value through profit or loss.

Analysis of comments received

21. With regard to the proposed elimination of embedded derivative accounting the exposure draft asked constituents for input on the following question:

    Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

22. Some respondents agreed with the proposals as they consider the current embedded derivative accounting model as a significant source of complexity in accounting for financial instruments.

23. However, many respondents, mainly preparers, preferred keeping or modifying the current bifurcation model, for the following reasons:

    (a) **The proposals would lead to volatility.** As a host contract would no longer be split and be eligible for amortised cost, income volatility would be increased.

    (b) **The proposals aggravate the issue of own credit risk.** For hybrid contracts that have financial liability hosts, measuring the entire hybrid contract at fair value through profit or loss will exacerbate the issue of recognising changes in own credit risk in profit or loss which they believe does not provide useful information. Some commentators recommended that any decision on the accounting for hybrid contracts (at least for hybrid contracts with financial liability hosts) should be deferred until the Board has concluded its project on reflecting own credit risk in liability measurement.

    (c) **Bifurcation accounting in many circumstances would better reflect the underlying economics and risk management considerations in the transaction**. Elimination of bifurcation accounting would also contradict the business model view of the proposed classification model as the components of many instruments are managed separately. For example, a deposit liability might be managed as part of the funding book whereas embedded derivative features that were included in the liability in order to encourage savers to make the deposit would be transferred to a derivatives risk management book. Those respondents considered bifurcation accounting as "good" complexity as it renders more decision-useful information if it reflects the way the entity manages risk.

(d) **The proposals would account for like things differently and would create structuring opportunities**. For example an entity could enter into two separate transactions that have the same economic effect as entering into a single hybrid contract, but would be accounted for differently. This would contradict the qualitative characteristic of 'substance over form' and would impair comparability.

(e) **Never change a running system.** The current guidance is well understood by all constituents and consistent application has evolved in practice in areas of uncertainty. If at all, changes should be made only where current guidance (or lack of it) leads to divergence in practice.

24. Some respondents also highlighted that the fair value option should be retained if the current approach in IAS 39 is retained. This topic is discussed in agenda paper 6 for this meeting.

Possible approaches for the Board

25. The Board has the following alternatives:

(a) to finalise the guidance as proposed in the ED

(b) to keep the existing guidance in IAS 39, or develop new guidance, to determine **the item (component of a hybrid contract)** to which the classification model would be applied[2]; or

(c) to keep the existing guidance in IAS 39, or develop new guidance, for **classification** purposes (this would be similar to the FASB approach).

26. The Board could defer any decision on the accounting for hybrid contracts with financial hosts until consideration of hybrid contracts with hosts outside the

[2] This is consistent with Alternative 1A of agenda paper 3A1 of the June 2009 meeting.

scope of IAS 39, and/or when deliberations on own credit risk are completed (which might for financial instruments happen within this project).

27. However, as the proposals in the ED are expected to be finalised in time for early adoption by 2009 year-end reporting entities, deferring a decision on this issue could be an impediment for early adoption. Depending on the outcome of such later deliberations entities would have to change their accounting again or, alternatively, if any form of grandfathering was granted, users have to deal with multiple accounting treatments for similar contracts.

28. Hence the staff does not recommend deferring this decision.

Staff recommendation – alternative 1: the Board addresses own credit risk

29. **The following recommendation applies if the Board decides to address the concerns with own credit risk by requiring one of the two approaches in paper 2 for particular financial liabilities.**

30. **The staff recommends eliminating bifurcation accounting for all hybrid contracts with financial hosts as proposed in the ED.**

Staff analysis

Reducing complexity

31. The staff believes that the elimination of the embedded derivatives guidance for hybrid contracts with financial hosts as proposed in the ED would reduce the complexity in financial reporting of financial instruments by eliminating another classification approach and improve the reporting for financial instruments. Many constituents agreed with this conclusion.

32. Keeping the existing guidance, for whatever purpose it is used, would perpetuate the complexity, inconsistency and lack of principles evidenced in today's requirements. On the contrary, in the staff's view approaches retaining or

modifying the existing guidance would not meet this project's objective of improving reporting for financial instruments and hence should not further be pursued.

Component of a contract

33. The proposed approach would also ensure that no virtual components of a contract (or 'units of account') are created that imply separate future streams of cash flows where in fact there will be only one stream of interrelated cash flows arising under the contract.

34. The staff does not think that the underlying rationale for bifurcation accounting was to reflect risk management activities (this one of the objectives of hedge accounting), but to avoid circumventing the recognition and measurement requirements for derivatives. That is, it is an exception to the definition of the unit of account (the contract) to avoid abuse[3]. The staff observes that generally constituents are opposed to:

    (a) exceptions to a principle; and

    (b) anti-abuse considerations as the underlying rationale for developing guidance.

35. Hence, the staff thinks arguments brought forward that the proposed approach would not reflect risk management are not valid.

36. The staff further thinks the concerns brought forward that this would not reflect the business model in which the hybrid contracts are held are flawed as those commentators generally focus on the risk management aspects laid out above, rather than the cash flow aspects of the business model. Staff has been repeatedly told that there is a big difference between managing cash flows and monitoring risk. The staff shares this view[4].

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[3] Cf. IAS 39.BC37.
[4] See also paragraph 43 of agenda paper 3B of the 29 September 2009 meeting.

37. Furthermore, the staff accepts that an entity could easily circumvent the provisions by entering into two transactions. However, two contracts represent two units of account and lead to two streams of cash flows (assuming no netting arrangements exist). This raises a broader issue of what the most useful unit of account for reporting financial instruments is and whether linkage of transactions is necessary to ensure accounting reflects substance and not merely form[5]. Staff notes that reconsideration of the basic unit of account does not form part of this phase of the project, forms part of a far broader issue for financial reporting and attempting to address this issue would ensure that any timetable of the Board is not met.

38. The arguments brought forward that the embedded derivative features often do not meet the 'basic loan feature' criterion and hence lead to the entire hybrid contract to be accounted for at fair value through profit or loss are valid[6]. However, the staff believes that the outcome provides more relevant information than today's accounting as the embedded derivative feature impacts the ultimate cash flows arising from the instrument. Having a single unit of account, the contract, to which the classification model is applied increases decision-usefulness as the information provided depicts more faithfully the amount, timing and uncertainty of future cash flows.

39. The staff understands the concerns raised over the 'landslide' effect when measuring the entire hybrid contract at fair value through profit or loss. Respondents were particularly concerned over this in connection with the issue of own credit risk.

40. We think that this issue is sufficiently mitigated through the proposed alternative measurement or presentation for some financial liabilities as discussed in agenda paper 2, including some hybrid financial liabilities.

[5] The staff thinks that the current unit of account in most cases appropriately reflect the economics underlying the transactions.

[6] While this might be true for the type of hybrid contracts, commentators did not provide a quantitative analysis of the impact.

41. Further, advocating bifurcation raises the question where componentisation should stop. This has been a recurring practice (and IFRIC) issue in the context of today's embedded derivative requirements. For example, should all financial instruments be decomposed into their components if risk is monitored and managed that way (a 'risk management view')? And does this result in more useful information? What is the nature of a 'host' contract (equity or debt)? Should you have to determine the host before identifying the derivative? Etc. Etc. Etc.

42. Lastly, we think accounting for the hybrid contract as one unit of account is consistent with the project's objective – to improve decision usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows and reduce complexity in reporting financial instruments.

Elimination of embedded derivative accounting for hybrid contracts with hosts that are within the scope of IAS 39
If the Board decides to address the concerns with own credit risk by requiring one of the two approaches in paper 2 for particular financial liabilities: Does the Board agree with the staff recommendation to eliminate embedded derivative accounting for hybrid contracts where the host is within the scope of IAS 39 and assess the entire hybrid contract under the proposed classification model? If not, what does the Board wish to do, and why?

Staff recommendation – alternative 2: the Board does not address own credit risk

43. **This recommendation applies if the Board decides not to adopt one of the two approaches in paper 2 to address the concerns regarding changes in own credit risk.**

44. Many respondents to the ED, including users, have highlighted that eliminating bifurcation accounting for hybrid contracts that are financial liabilities increases the volatility in profit or loss created by changes in own credit risk. Those respondents stated that for hybrid financial liabilities, the host contract is often managed on a contractual yield basis and hence, any changes in fair value including changes in own credit risk relating to the host will rarely, if ever, accrue to the entity.

45. As evidenced in the comment letters, many believe that if a hybrid contract with a financial liability host is held to pay the contractual cash flows, reflecting changes in own credit risk in the income statement is misleading and not decision-useful. They encouraged the Board to further pursue its project on credit risk in liability measurement before finalizing the proposals for hybrid contracts that are financial liabilities.

46. **On balance, we believe that if the Board does not address the issue of own credit risk, the requirement of bifurcation accounting for hybrid contracts with financial liability hosts should be retained. We further recommend that the bifurcation criteria are ultimately aligned with the overall classification model.** (That bifurcation approach is described below.)

47. We think it would be an improvement of financial reporting to eliminate bifurcation for all hybrid contracts with financial hosts. However, in the staff's view, the issues raised by constituents in relation to own credit risk if financial liabilities are measured at fair value outweigh the incremental benefits from eliminating bifurcation accounting for hybrid contracts with financial liability hosts.

48. **However, we recommend eliminating bifurcation accounting for hybrid contracts with financial asset hosts** as the concerns over own credit risk do not arise for assets. The staff acknowledges that having two different models for hybrid contracts with financial hosts is far from optimal. However, the staff thinks the issues surrounding own credit risk justify the different accounting treatment.

Aligning bifurcation criteria with the overall classification model

49. Aligning the bifurcation criteria with the classification model would better articulate the rationale for requiring amortised cost or fair value measurement in the classification model and in the bifurcation approach. In our view, this also minimises structuring opportunities.

50. Many of the comments received noted that hybrid contracts with financial liability hosts often have a funding or host component that the entity manages on a contractual yield basis.

51. Those commentators believed it would better reflect the actual business model if this funding or host component is accounted for at amortised cost. The remaining “other” component of the contract would appropriately be accounted for at fair value through profit or loss.

52. The staff thinks that any host component must meet the two criteria of the classification model in order to be bifurcated and accounted for at amortised cost (using the terminology of the ED):

    (a) it is managed on a contractual yield basis, and

    (b) it has basic loan features.

53. All other hybrid contracts would be accounted for at fair value through profit or loss in their entirety.

54. However, this approach would require further research and development of guidance (eg how to identify the host component/the other component). Given the timetable the Board has signed up to we do not think it is feasible to fully develop the model considering all potential ramifications in time. **As an interim measure, the staff recommends that the Board should retain the IAS 39 bifurcation model for hybrid contracts with financial liability hosts for the time being and develop a new bifurcation model for such contracts subsequently.**

Retain bifurcation accounting for hybrid contracts with financial liability hosts, but eliminate bifurcation accounting for hybrid contracts with financial asset hosts
1. Does the Board agree with the staff recommendation to retain the IAS 39 bifurcation accounting for hybrid contracts with financial liability hosts? If not, why and what does the Board wish to do, and why? 2. Does the Board agree with the staff recommendation to eliminate bifurcation accounting for hybrid contracts with financial asset hosts? If not, why and what does the Board wish to do, and why?